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PACIFIC TELESIS
Group - Washington

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

March 10, 1993

Donna R. Searcy
Secretary
Federal Communications Commission
Mail Stop 1170
1919 M Street, N.W., Room 222
Washington, D.C. 20554

Dear Ms Searcy:

Re: *CC Docket No. 92-296 - Simplification of the Depreciation Prescription Process*

On behalf of Pacific Bell and Nevada Bell, please find enclosed an original and six copies of its "*Comments*" in the above proceeding.

Please stamp and return the provided copy to confirm your receipt. Please contact me should you have any questions or require additional information concerning this matter.

Sincerely,

Sherry Herauf

Enclosures

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OFFICE OF THE SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Simplification of the Depreciation Prescription Process	)	CC Docket No. 92-296
	)	

COMMENTS OF PACIFIC BELL AND NEVADA BELL

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Date: March 10, 1993

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SUMMARY

Pacific Bell and Nevada Bell ("The Pacific Companies") support the Commission's continuing efforts to reduce unnecessary regulatory burdens and their associated costs. In this proceeding designed to simplify the depreciation prescription process, the Commission can also accomplish another important policy goal for price cap carriers. That is, consistent with the Commission's public policies that led to its adoption of incentive based regulation, the Commission can permit carriers to react to technological and marketplace conditions in a timely manner. This can occur by providing carriers with the ability to set appropriate depreciation rates. The historical depreciation prescription process may have been suited to rate of return regulation, but, given the endogenous character of increases in depreciation expenses, micro-management of the depreciation prescription process is no longer appropriate. Instead, the Commission should select a new process that permits price cap carriers to exercise the decision-making ability that justified the Commission's decision to treat depreciation expense changes as endogenous.

Several general suggestions apply to any of the options proposed by the Notice of Proposed Rulemaking. The Commission must tailor any option chosen (other than the price cap carrier option) to further its intent to provide price cap carriers with greater flexibility in responding to current technological and market demand. The option chosen must also apply to all accounts in order to simplify the administrative burden in any meaningful

way. And, the chosen option must make provision for the continued acceleration in technology and marketplace changes.

The price cap carrier option would accomplish the Commission's simplification and is the only option that is logically consistent with price cap goals. This option will permit carriers to propose initial depreciation rates without diminishing the Commission's ability to fulfill its statutory obligation to insure reasonable rates. Carriers could continue to Statements A, B and C which they currently file. This will provide the Commission with the depth of information it uses now to determine depreciation rates. If more information is needed or if the rates proposed are unacceptable, the Commission may require further data or reject the proposal. Because the carrier's proposal will be subject to public notice, both state regulators and other interested parties will have an opportunity to participate in the Commission process.

The concern that carriers may use the depreciation prescription process to the detriment of the ratepayers is speculative, unrealistic and protected against by safeguards. First, the endogenous treatment of depreciation expense changes prevents significant ratepayer effect. Second, safeguards such as monitoring through ARMIS reports, state regulatory scrutiny, the potential negative effects of inconsistent net income reports on investors and the Securities Exchange Commission and the natural long-term effect of accelerating depreciation accruals protect against significant changes in depreciation expenses from year to year.

Of the three other options proposed by the NPRM, the depreciation schedule option should be rejected because it will not reduce the administrative burden. If the Pacific Companies' understanding is accurate, tracking accruals by vintage would be required. That will create significant accounting complexity. Moreover, as the NPRM points out, this option would result in the greatest deviation from accuracy in matching allocation of costs with plant consumption.

On the other hand, the basic factor range and the range of rates options, while not the Pacific Companies' preference, can be workable if broader ranges are permitted for price cap carriers; if the option is applied to all accounts; and if the Commission would use carrier-determined parameters that are forward-looking to establish the ranges.

Finally, the proposal to eliminate salvage from the depreciation process should be rejected as contrary to generally accepted accounting treatment. Moreover, it would not simplify the carrier's administrative burden but would merely shift the burden to accounting and financial processes.

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COMMENTS OF PACIFIC BELL AND NEVADA BELL

Pacific Bell and Nevada Bell ("the Pacific Companies") respectfully submit their comments on the simplification of the depreciation prescription process proposed in the above-captioned proceeding.[1]

I. INTRODUCTION

The Commission's efforts to reduce unnecessary regulatory burdens and their associated costs by undertaking simplification of the depreciation prescription process is laudable. The Pacific Companies support all such efforts. The current depreciation prescription process is an outstanding example of a regulatory oversight process that has lasted far longer than warranted. The Commission correctly assesses the

1 Simplification of the Depreciation Prescription Process, CC Docket No. 92-296, Notice of Proposed Rulemaking, released December 29, 1992 ("NPRM").

need to revise the present micro-managed depreciation process to meet the reality of changing regulations, technological advance and increasing competition. This proceeding conveys the Commission's genuine intent to streamline today's burdensome and costly process.

The current process is resource-intensive and cumbersome. For Pacific Bell, preparation for the triennial represcription begins twelve months before we submit our proposed depreciation rates to the Commission. The development and assemblage of study material consumes innumerable people-hours. For the 1991 triennial represcription, Pacific Bell's direct expenses were in excess of $1M. Approximately two dozen people make up the team which spent about a year putting together study binder material, which numbered over 900 pages. Nevada Bell's 1991 study consisted of more than 600 pages of data prepared by its permanent staff equivalent to three and one-half employees.

The Pacific Companies also welcome the examination of the depreciation prescription process because the current process does not provide for proper depreciation recovery now. Despite the Commission and carriers' efforts,[2] capital recovery is incomplete. For example, the Commission's efforts successfully addressed the 1987 depreciation reserve deficiency. However, the

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2 Amendment of Part 31 (Uniform System of Accounts for Class A and Class B Telephone Companies) so as to Permit Depreciable Property to be Placed in Groups Comprised of Units with Expected Equal Life for Depreciation under the Straight-Line Method, Dkt. No. 20188, Report and Order, 83 FCC 2d 267 (1980); Amortization of Depreciation Reserve Imbalances of Local Exchange Carriers, CC Dkt. No. 87-447, Report and Order, 3 FCC Rcd 984 (1988).

current prescribed factors for some accounts have once again resulted in a deficiency. For example, in 1991, fairly soon after the previous adjustment, there was a reserve imbalance of $1.8B based on Pacific Bell's proposed parameters. Using the Commission's prescription factors, the deficiency was $591M. And, the limitations of the present process that contribute to an imbalance will be exacerbated by accelerating technology changes and competition in basic markets, conditions that once, but no longer, were described as occurring "in the future".

Simplification of the depreciation represcription process is also timely in light of the rapid market changes prompting competition in carrier services. The Commission recognizes the increasingly complex and competitive environment in which carriers operate and that competition demands greater flexibility.[3] Competition makes the future uncertain; future capital recovery is also uncertain. And, under the best of circumstances, a lag exists between market conditions and regulatory oversight. That lag results in fundamental unfairness when not all competitors have similar regulatory burdens.

Regulatory lag and a requirement of total control as a check on carriers' activities hinder their ability to respond to competition. Price cap regulation is the remedy which enables carriers to respond quickly to changing technology and market demands. Because the Commission rightly favors marketplace

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3 See Policy and Rules Concerning Rates for Dominant Carriers, 5 FCC Rcd 6786 (1990) ("Price Cap Order"), paras. 27 and 28.

regulation, the Commission must move away from its current micro-management of the depreciation rate prescription process which is unnecessary and undesirable in the context of incentive regulation.

The Pacific Companies welcome all efforts by the Commission to reduce the administrative burden on both carriers and the Commission and to improve a carrier's ability to respond to market demand. Eliminating unnecessary regulatory oversight will allow limited Commission and carrier resources to be focused on critical issues such as infrastructure development and marketplace response. Moreover, our mutual goal of developing advanced telecommunications infrastructures -- electronic superhighways of the information age -- will only be possible with sound depreciation policies that include permitting carriers to make reasonable and timely depreciation decisions based on their expert assessments of technology and market conditions.

II. DISCUSSION

A. General Comments

Before commenting on the specific options proposed by the NPRM, the Pacific Companies urge the Commission to consider the following suggestions which will help accomplish its goals, whatever option is finally selected.

First, any method that is chosen (other than the price cap carrier option) must be tailored in its application to price cap carriers. The Commission's goals under price caps regulation require distinctive treatment of price cap carriers. For example, ranges for price cap carriers must be broader than permitted for non-price cap carriers because the Commission intended to provide price cap carriers with the ability to be more responsive to market changes. The endogenous treatment of changes in depreciation rates and expenses also warrants tailoring the designated option for price cap carriers. Further, since it is the overall outcome that is most critical, the Commission should allow wide ranges for individual accounts and set a zone of reasonableness for the overall change in depreciation expense level. Any overall change requested within that zone would be presumed reasonable. Additional depreciation studies would not be required. However, a request for a change outside the zone would require a full depreciation study of the responsible account(s).

The companies already provide a comparison of the actual reserve to the theoretical reserve.[4] An additional test for reasonableness could include a comparison of the overall ratio of depreciation reserve to plant-in-service to the ratio for emerging marketplace competitors. A statement of review by an external auditor could be another test for reasonableness of the proposed depreciation rates. Any of these reasonableness tests would ensure that depreciation accruals were appropriately matched to the economic life of the plant.

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[4] This data is provided by Statement C in the current filing process.

Second, the ranges should be the same whether assets are owned by local exchange carriers or by interexchange carriers.[5] Pacific Bell uses the same 4ESS tandem switching machines and interoffice equipment that interexchange carriers do -- and we will shortly compete with them for the same intraLATA toll customers. The Commission's collocation decision will require local exchange carriers to have cost structures for interoffice transport assets that are competitive with interexchange carriers. For these assets, there should be no difference in the ranges applied to the two entities.

Third, the option chosen must apply to all accounts, not just a select few. Halfway measures will accomplish nothing. Only by completely stripping away needless layers of regulation can real progress be made. The Commission's concern that it should gain some experience with the use of ranges before it establishes them for all accounts[6] will unnecessarily delay and thwart the benefits of simplification. The Commission's proposal to apply Option A or B (Basic Factors Range or Range of Rates) to accounts for which ranges can be easily determined, then to build on that experience for accounts that are less adaptable to ranges is not likely to accomplish much in that the

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[5] Factors underlying the ranges for support assets (Account 32.2110) should be the same for local exchange carriers and interexchange carriers. The Pacific Companies are not aware of factors that would cause different lives for motor vehicles, buildings, general purpose computors or the other assets in this primary account.

[6] NPRM, para. 16.

accounts which generate the most work will not be among those initially tackled.

Fourth, in its deliberations of the appropriate option, the Commission must consider the changed circumstances that make this simplification proceeding urgently needed. And, as technology and marketplace changes continue at an accelerated pace, the Commission will need to allow even more depreciation rate flexibility and further simplify processes so that price cap carriers will have the flexibility needed to respond to the changing marketplace.

B. Options:

1. The Price Cap Carrier Option Meets Both Commission And Carrier Goals.

The expressed intent of this proceeding is to reduce unnecessary regulatory burdens and the associated costs by simplifying the depreciation prescription process.[7] Option D would permit price cap carriers to file their proposed depreciation rates. The proposed rates would then be opened to public comment. After review, the Commission would prescribe depreciation rates based on the carrier's proposals and comments submitted.

The price cap carrier option (Option D) is by far the method to accomplish the Commission's objectives in this

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[7] NPRM, para. 1.

simplification docket. It is also the only option that is solidly grounded in the Commission's regulatory philosophy of incentive regulation. In adopting an incentive-based system of regulation, the Commission stated that its objective is "to harness the profit-making incentives common to all businesses to produce a set of outcomes that advance the public interest goals of just, reasonable and nondiscriminatory rates, as well as a communications system that offers innovative, high quality services."[8] Moreover, the Commission recognized that "Opportunities presented by incentive regulation for enhancing efficiency in the LEC industry include the opportunity to provide better incentives for innovation.... In our view, innovation in how a company produces its output is one of the chief ways a company becomes more productive and efficient."[9] The ability to recover costs through sound depreciation practices is a significant influence in how a carrier decides to produce its output. And, having a carrier initially suggest its depreciation rates, as proposed by the price cap carrier option, is but one of the opportunities for enhanced efficiency possible under incentive regulation. As such, the price cap carrier option is a logical continuance of the Commission's objectives for incentive regulation. The price cap carrier option will best permit the price cap carriers to exercise reasonable judgement in their

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8 Price Cap Order, para. 2.

9 Id., para. 32.

proposals for depreciation rates while maintaining the Commission's ability to determine the prescribed depreciation rates. None of the other options proposed, in which the Commission decides on factors, ranges or schedules, are complementary to the Commission's incentive regulation philosophy.

Contrary to expressed concern,[10] this option offers the Commission as much control as it has today. The Pacific Companies suggest that carriers file the current Statements A, B and C (Attachment 1)[11]. Statement A compares the currently prescribed depreciation rates and the associated life, salvage and reserve components with the proposed rates (and the similar associated components). Statement B details the depreciation expense produced by the prescribed rates, the depreciation expense produced by the proposed rates and the difference between the two. Statement C reports the depreciation reserve data by specific account and includes the following data: investment in service as of the rate study date; book depreciation reserve; book depreciation reserve percentage; average service life; average remaining life; average net salvage; future net salvage; reserve requirement amount and percent.

These three statements will continue to provide the Commission with the depth of information that the Commission can

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10 See Commission's Duggan's Comments.

11 Attachment 1 shows these schedules from Pacific Bell's 1991 Depreciation Prescription filing.

use in its reasoned analysis. Moreover, if the proposed rates do not meet Commission approval, the price cap carrier option would not preclude the Commission from rejecting the proposed rates and requiring additional or new data.

The adoption of the price cap carrier option furthers a most important Commission goal of price cap regulation -- to reduce the micro-management of carrier matters. And, that goal can be met without diminishing the Commission's ability to fulfill its statutory obligation to insure reasonable rates. Under the price cap carrier option as described by the NPRM, the Commission would ultimately decide the depreciation rate. The price cap carrier option merely means that the Commission's deliberation begins with rates proposed by the carrier. If the proposed rates are not acceptable, the Commission has the authority to deny the request and/or to require a further proposal that is acceptable. The Commission can also require supplemental data from the carriers to further investigate the reasonableness of the proposed rates.

Establishing a new, simplified method of prescribing depreciation rates is a perfect opportunity for the Commission to step away from micro-management. As the Commission recognizes, within price cap regulation, depreciation expense is entirely irrelevant to the Commission's control of price cap carriers.[12] The Commission notes that the price cap plan encourages carrier efficiency without allowing carriers to pass

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12 NPRM, para. 8.

depreciation expense charges on to ratepayers.[13] Thus, the kind of microscopic, expensive scrutiny historically provided under rate of return regulation is no longer necessary or appropriate for price cap carriers.[14] The Commission must certainly continue to monitor the overall level of depreciation but consistent with the goals of price cap regulation, account-by-account micro-management must be eliminated.

The price cap carrier option also supports the Commission's rationale for treating depreciation expense as an endogenous cost. The Commission has said that the endogenous treatment is based on the carriers' control of their own plant retirement and deployment plans.[15] While the timing of those events may be within a carrier's control, heretofore, the extent of depreciation expense has been based on Commission judgement. The price cap carrier option permits the carrier to exercise its own judgement as to the extent of depreciation expenses. Depreciation policy will then truly be the responsibility of management with the Commission providing oversight pursuant to

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13 Although higher depreciation expenses can lead to lower earnings for carriers, actions to accomplish that are highly unlikely, as explained below.

14 An argument could be made that the time-consuming (and costly) process of account-by-account prescription was unnecessary even under rate of return regulation because account by account prescription was not used in the rate making process. The Separations process is only concerned with the primary plant accounts (47 C.F.R. §36.361). Thus, depreciation applied on an account-by-account basis far exceeds what is needed for the rate-making process.

15 Price Cap Order, paras. 182-187; NPRM, para. 23.

its statutory obligations. This is only fair since it is apparent that the Commission's rationale for endogenous treatment of depreciation expense would potentially also apply to accumulated depreciation imbalances. The carrier is solely at risk for capital under-recovery.[16] The write-offs taken by AT&T and MCI several years ago exemplify the need to be able to make such responses. Increasing competition faced by LECs argues for the Commission to work with carriers to set proper depreciation rates reflective of the marketplace.

Moreover, concerns that carriers may have an incentive and opportunity to manipulate depreciation expense in order to produce lower earnings (and preclude the possibility of sharing) are not supportable. Such concerns are purely speculative and, given the safeguards protecting against such behavior, unrealistic. Any unreasonable effect on sharing is protected against by existing safeguards: monitoring ARMIS reports will reveal any radical swings in depreciation expenses; state regulators scrutinize depreciation expense with as much concern as the Commission; independent auditors can be asked to attest to a carrier's compliance with regulatory and accounting requirements concerning depreciation expense; and net income reports that are inconsistent with prior periods would concern the Securities Exchange Commission ("SEC") and trigger SEC investigation. Moreover, significant swings in net income caused by rapid changes in depreciation expenses would not be positively

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16 NPRM, paras. 23 and 24.

received by the financial community. Unless a carrier is earning above the 100% cap, any increase in depreciation expenses lowers the carrier's reported net income. A carrier that attempted to decrease sharing by proposing large increases in depreciation pays a high price through lower net income. Net income and earnings per share are significant drivers of public utility stock prices. Reducing earnings per share would negatively affect shareholder perception and investment by potential shareholders.

Finally, long term effects will deter any interest in inappropriately accelerating depreciation accruals. If a carrier increases the depreciation accrual, it reduces the rate base. After a few years, the impact of the smaller rate base totally offsets the higher depreciation accruals and the amount of sharing becomes greater than it would have been if depreciation had not been increased. If the carrier increases depreciation even more, the rate base is further reduced. As the net rate base grows smaller as a result of depreciation, ever increasing accruals would be required to avoid sharing. But, increasing accruals have the spiraling effect of speeding the decline of the rate base. Thus, acceleration begets ever-increasing acceleration.

The Pacific Companies also favor the price cap carrier option because of the simplicity of the prescription process offered by this option. Such simplicity reduces the administrative burden for both price cap carriers and for the Commission, one of the Commission's goals in this proceeding.

Any reduction in the extent of support that carriers must provide will reduce the administrative resources expended for the represcription process. The price cap carrier option is likely to significantly reduce costs because supporting data would not be part of the depreciation rates filing.[17] While the true cost of Pacific Bell's participation in the 1991 triennial represcription has not been determined, the cost for printing and information gathering, presentations to regulators, and other related expenses was in excess of $1M. If the California Public Utilities Commission were also to agree to the same kind of simplified depreciation process, the costs could be reduced by 80%, to approximately $200,000.[18] If, however, the state were to maintain its current processes, Pacific Bell estimates that the adoption of the price cap carrier option would reduce the current level of expenditures by 50%. Even these figures, however, do not reveal the full extent of any savings. Eliminating layers of unnecessary administrative rules and procedures is obviously cost-effective. The extent of that efficiency, however, can only be determined as the layers of unnecessary administrative cost are eliminated.

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17 NPRM, para. 12.

18 The CPUC process for depreciation prescription is already considerably simplified. Studies and study material are limited to certain specified accounts. Consequently, the California depreciation prescription process does not require the extensive resources necessary for the federal depreciation rates study requirements.

The Commission inquires whether the price cap option would be consistent with the statutory requirement that the Commission notify and provide opportunity for each state commission having jurisdiction with respect to the carrier to present its views and recommendations.[19] This statutory requirement can be fulfilled by providing for public notice and an opportunity for comment, both of which the Commission proposed as an important part of the price cap carrier option. To insure notice to the responsible jurisdictional agency, the Commission could require a carrier to serve a copy of its filing on its state regulators. The state commission will have full opportunity to present its views in the comment cycle.

2. The Depreciation Schedule Option Must Be Rejected.

The depreciation schedule option (Option C) would establish a depreciation schedule for each plant account based on Commission-specified average service life, retirement pattern and salvage value. Carriers would apply the schedule to their investment by vintage.[20]

While the Commission describes this option as affording the greatest degree of simplification, it is not clear how this option would operate. The depreciation schedule option appears to be a variation of options A and B but instead of providing for

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19 NPRM, para. 42.

20 Id., para. 11.

a range of depreciation factors or rates, requires accounting by vintage, which is much more complex. If this is an accurate interpretation of Option C, the new process will be anything but simple. Tracking accruals by vintage will create significant accounting complexity and cost. As such, Option C is inconsistent with the Commission's goal to simplify regulatory burdens.

The Commission has also already identified one drawback to this option -- that this method would lead to the greatest deviation from accuracy in matching allocation of costs with plant consumption.[21] As proposed, Option C also offers the least flexibility for carriers to respond to changes in technology and service demands. Given these significant negative aspects and the more positive possibilities of the other options, Option C must be rejected.

3. Options A and B May Be Acceptable If Properly Structured.

The Commission's two remaining options, the basic factor range (Option A) and the range of rates (Option B), while not the Pacific Companies' preferred options, could be workable methods to determine depreciation rates.

The basic factor range option (Option A) would establish ranges for the basic factors that determine the parameters used in the depreciation rate formula. Carriers would not be required

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21 NPRM, para. 33.

to submit detailed studies in support of their proposed factors.[22] Carriers would select the future net salvage (FNS), projection life and survivor curve for each applicable account from within an established range. The basic factors would be used to derive the parameters that determine the depreciation rate. Rates would be applied to applicable account balances to calculate the depreciation expense.[23]

The depreciation rate range option (Option B) provides for the Commission to establish ranges for depreciation rates themselves, further simplifying the depreciation process by eliminating the need for basic factors and for the depreciation rate formula. Carriers would continue to apply depreciation rates to their plant account balances to determine depreciation expense.

As proposed, Options A and B are too narrow for price cap companies. However, as previously described[24] if these options are tailored to provide broader ranges consistent with the goals of incentive-based regulation and if applied to all accounts, these options would be an improvement over the current process. Moreover, the usefulness of Options A or B will hinge

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22 NPRM, para. 9.

23 Id., para. 13.

24 See previous discussion at pp. 4-6.

on the factors that the Commission uses in its analysis.[25] Carriers should propose the factors that the Commission considers. Those factors should be forward-looking and take into consideration current and near-future data that can affect carriers' depreciation decisions. Heretofore, the Commission has relied extensively on historical data to establish future rates. If the historical factors used for current prescribed rates form the basis for the proposed ranges, the latest impacts of the marketplace and technology will not be taken into consideration. The depreciation ranges which will govern future depreciation expenses should be based on the current trends of the industry. Given the accelerated pace of regulatory, technological and marketplace changes, depreciation rates based on historical, not forward-looking, factors will always be behind the change curve -- and have the effect of preventing carriers from setting depreciation rates that respond to those changes.

If selected, Option A or B should be mandatory for all carriers and implemented either all at the same time, i.e., flash cut, or no later than the next prescription cycle, at the carrier's discretion. Permitting the carrier to choose when the simplified method would apply will ease the administrative burden the Commission anticipates from a flash cut applicable to all carriers. Options A and B should also include a provision which would permit a carrier to file a full study when unique

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25 As between Options A or B, there is probably only minor additional administrative savings for Option B over Option A.

circumstances (such as significant divergence between expected depreciation expense and that resulting from the use of ranges) justify rates outside of the determined range. Carriers whose current depreciation rates allow for slower recovery than the ranges selected under options A or B should be phased into the prescribed range over five years or less, as determined by the carrier.

Carriers should be permitted to select from within the established range and revise that choice no more than annually. This will permit greater responsiveness to technology and market conditions but, as discussed previously, will not provide unreasonable incentives to revise rates depending on that year's actual earnings projections.

The ranges used in Options A and B should be checked periodically. Once initial rates are established, high technology accounts should be checked annually to ensure that the ranges continue to be reasonable when compared with industry studies.[26] More stable accounts may need less frequent adjustment. In any event, all accounts should be reviewed within three to five years. The annual update process carriers may now use would not be necessary. When a complete review is undertaken, the ranges should be updated based on forward looking, competitive, industry benchmark studies including technology and customer demand studies. Under Option B

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26 Commercially available studies which forecast asset lives and technological direction are available, for example, from Technologies Futures Incorporated.